Draft

STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**04/10/07**	Bill No:	**AB 1012**
Tax:	**Property**	Author:	**C. Calderon**
Related Bills:			

BILL SUMMARY

This bill would require the Board of Equalization (Board) to conduct two annual studies related to the property taxation of petroleum properties: (1) a market price forecast study for crude oil and natural gas over a 20 year period, and (2) a discount rate study.

ANALYSIS

CURRENT LAW

Regulatory Assessment. The Division of Oil, Gas, and Geothermal Resources of the Department of Conservation imposes a fee on producers of oil, currently at a rate of 6.2 cents per barrel of oil produced. The fees are assessed for purposes of financing the regulatory work of that division. (Article 7 (commencing with Section 3400) of Chapter 1 of Division 3 of the Public Resources Code.)

Property Tax – Valuing Proved Reserves. Under Property Tax Law, with respect to oil in the ground, "proved reserves" are subject to property tax assessment by county assessors. Section 468 of Title 18 of the California Code of Regulations (Property Tax Rule 468) provides that the right to remove petroleum and natural gas from the earth is a taxable real property interest. Increases in recoverable amounts of these minerals caused by changed physical or economic conditions constitute additions to such a property interest. Reduction in recoverable amounts of minerals caused by production or changes in the expectation of future production capabilities constitute a reduction in the interest.

The market value of an oil and gas mineral property interest is determined by estimating the value of the volumes of proved reserves. Proved reserves are those reserves which geological and engineering information indicate with reasonable certainty to be recoverable in the future, taking into account reasonably projected physical and economic operating conditions.

Present and projected economic conditions are determined by reference to all economic factors considered by knowledgeable and informed persons engaged in the operation and buying or selling of such properties, e.g., capitalization rates (i.e., discount rate), product prices (price forecasts) and operation expenses.

Income Approach. Section 8 of Title 18 of the California Code of Regulations (Property Tax Rule 8) outlines the principles to be applied in using the income approach for valuing property for purposes of the property tax. Subdivision (g) of Property Tax Rule 8 provides that the capitalization rate may be developed by either of two means:

- **Market Derived.** By comparing the net incomes that could reasonably have been anticipated from recently sold comparable properties with their sales prices, adjusted, if necessary, to cash equivalents.

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- **Band of Investment Method.** By deriving a weighted average of the capitalization rates for debt and for equity capital appropriate to the California money markets (the band-of-investment method) and adding increments for expenses that are excluded from outgo because they are based on the value that is being sought or the income that is being capitalized.

PROPOSED LAW

This bill would add Section 726 to the Revenue and Taxation Code to require the Board to conduct two studies that may be used by counties when determining the assessment on petroleum properties. The studies would be jointly conducted with the Division of Oil, Gas, and Geothermal Resources in the Department of Conservation (Division). The Board would be the lead agency conducting the studies. The cost of the studies would be funded from the proceeds of the annual charges on oil and gas producers levied by the Division. The studies would be done for two years, 2008 and 2009.

These provisions would be repealed January 1, 2010, unless later legislation extends that repeal date.

The two studies relate to two factors that are necessary in using the income approach to value proved reserves and would be conducted for both the years 2008 and 2009. The studies are:

- **Oil and natural gas market price forecast**. A forecast of the price of crude oil and natural gas, the regional posting price differentials for each field, and the projected market crude oil and natural gas prices for the next 20 years as of January 1, 2008 and January 1, 2009.
- **Discount Rate Study.** A discount rate study used to implement subdivision (g) of Section 8 of Title 16 of the California Code of Regulations and Section 468 of Title 16 of the California Code of Regulations.

The Board would be required to publish a summary of the results of the studies that includes the conclusions of the studies, the assumptions supporting those conclusions, and a glossary of the definitions and terms used in the studies.

BACKGROUND

Property Tax Rule 468 provides that the right to remove minerals from the earth is a taxable real property interest. Changes in the recoverable amounts of minerals will change the value of that interest. Proved reserves are defined and the steps are detailed to ensure that property values are estimated in accordance with relevant property tax laws.

Pursuant to Rule 468, the base year value for proved reserves must be adjusted annually to account for production and other changes to proved reserve numbers, and new construction and equipment removal must be accounted for.

The valuation procedures are set forth in Rule 468. First, the total current market value of the property is estimated. Values for the wells, improvements, and surface equipment actively used in property operations are determined and subtracted from the total value (becoming an offset). The result is the current taxable value of the reserves.

The volume of any change in proved reserves is estimated by subtracting the prior year's reserves, less last year's production (depletion), from the current estimate of reserves for the property.

The value of produced reserves is determined by multiplying the volume of the prior year's production by the weighted average value of reserves for all prior base years. The taxable value of the prior year's reserves remaining is found by subtracting the value of the prior year's production from the prior year's taxable value of reserves. The value of the change in reserves from other than production is found by multiplying the change in volume by the current market value per unit of the total reserves.

The current base year value for the reserves is the sum of the value of the prior year's reserves, less depletion, appropriately factored for inflation, added to the value of the changed reserves.

The base year value for land (other than mineral rights) and improvements is the value on lien date 1975, the date of new construction, or the date of a change in ownership subsequent to 1975. The base year value is factored each year the same as other real property in the state; however, if in any year the value declines below the adjusted base year for the total property, then the lower value is placed on the roll for that year.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the California Independent Producers Association (CIPA). According to the author, this bill is intended to provide standardization in the valuation of oil and gas reserves by providing a third party study that could be used. The study would be paid for by increasing the annual assessments on oil and gas producers.
2. **County assessors have a formal annual process in place to promote uniformity.** The Petroleum Standards Advisory Committee of the California Assessors' Association annually develops a price forecast and discount rates. This process commences each year with a joint assessor and industry conference.
3. **The Board is currently undertaking three studies related to the valuation of specific types of personal property used in certain high-tech industries.** The Board sponsored legislation (AB 2182, Mullins) last year to require these studies. The Board also sought and obtained the necessary funding for the studies through the Budget Act of 2006. These studies differ in that the results of those studies, if used, will provide a rebuttable presumption of correctness as to the values established. Additionally, the studies expressly include both taxpayers and assessors as participants in the study so that a team approach is being used from the start. The Board is in the early stages of these three studies.
4. **Competing Studies.** The use of the proposed studies is not required. It is possible that three competing studies would be presented to an appeals board in a valuation dispute: the assessor's, the taxpayer's, and the Board's, as all three could differ. This could result in confusion and time spent analyzing and reconciling the various studies and their methodologies.
5. **This bill provides funding for the Board for two years through increased fees that would be levied by the Department of Conservation.** However, the Board would likely incur costs beyond the actual two-year period. If appeals are filed at the local level, in which either the assessor or the taxpayer make reference to the

Board conducted study, Board staff could be subpoenaed to participate for a number of years after the study is completed.

6. **The Board may have some difficulty obtaining the data necessary to perform the studies.** It would be preferable to expressly require in law that property owners provide the Board with necessary data to perform the studies accompanied with protections to ensure confidentiality of the taxpayer data.
7. **Technical Error.** Property Tax Rules are included in Title 18 (not Title 16) of the California Code of Regulations. See references on line 14 and 15 of page 2.

COST ESTIMATE

Pending.

REVENUE ESTIMATE

This bill has no direct revenue impact.

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